Nos. 15983 and 15984

In the United States Court of Appeals for the Ninth Circuit

THOMAS M. ROBINSON, APPELLANT

v.

WILLIAM G. ELLIOT, APPELLEE

THOMAS M. ROBINSON, APPELLANT

v.

THOMAS W. ELLIOT AND EVELYN W. ELLIOT, APPELLEES

On Appeals from the Judgments of the United States District Court for the District of Montana

BRIEF FOR THE APPELLANT

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BRIEF FOR THE APPELLANT

OPINION BELOW

The opinion, findings of fact and conclusions of law of the District Court (No. 15983, R. 73-79, 81-88),[1] are not officially reported.

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[1] The above entitled cases were consolidated for trial. (No. 15983, R. 64, 106.) On this appeal the basic record in each case is printed separately (No. 15983, pp. 1-103 and No. 15984, pp. 1-64) as Volume I, and the transcript of proceedings in the District Court is printed as Volume II of both proceedings. Record references herein to the separate Volume I in each case will be so indicated.

JURISDICTION

These appeals are from judgments entered by the District Court of Montana (No. 15983, R. 89-90; No. 15984, R. 54-55) in separate suits brought by William G. Elliot (No. 15983, R. 3-12), and by Thomas W. Elliot and his wife (No. 15984, R. 3-12), herein sometimes referred to as the taxpayers, against Thomas M. Robinson, District Director of Internal Revenue for the District of Montana (No. 15983, R. 66, 81; No. 15984, R. 46), for recovery of amounts allegedly overpaid as federal income taxes for the taxable years 1946 through 1953, both inclusive, in the aggregate amounts of $18,658.86 (No. 15983, R. 11-12) and $17,657.86 (No. 15984, R. 11-12), respectively. Each suit was based upon separate refund claims filed by the respective taxpayers for each of the years involved. (No. 15983, R. 12-41; No. 15984, R. 12-35.) In No. 15983 it was stipulated by the parties (R. 66) that the refund claim filed by William G. Elliot for the year 1946 was not filed within the time limit required by Section 322(b) of the Internal Revenue Code of 1939, but that the claims filed by William G. Elliot for the years 1947 through 1953, both inclusive, were timely (R. 67-71), and that the complaint in his case was filed within two years of the taxpayer's receipt of the Commissioner's statutory notice of disallowance of his claims for the latter years (R. 71-72). In No. 15984 it was stipulated by the parties that refund claims for each of the years 1946 through 1953 were timely filed by the taxpayers (R. 46-50, 52), and that the complaint in that case was filed in that case within two years of the time of receipt by the taxpayers of statutory notices of disallowance of the claims for 1946, 1949, 1950, 1951, 1952, and 1953 (R. 50, 52-53). The suits were consolidated for trial (No. 15983, R. 64), and were submitted to the District Court on stipulations of fact, documentary evidence, and oral testimony (No. 15983, R. 65-73, 113-150; No. 15984, R. 45-53, 113-150), on the basis of which the District Court made findings of fact and conclusions of law (No. 15983, R. 81-88), and entered judgment in each case under date of October 31, 1957 (No. 15983, R. 89-90; No. 15984, R. 54-55).[2] The cases are before this Court pursuant to notices of appeal filed on behalf of the District Director of Internal Revenue on December 30, 1957. (No. 15983, R. 92; No. 15984, R. 57).[3] The jurisdiction of this Court is invoked under 28 U.S.C., Section 1291.

QUESTIONS PRESENTED

The question on the merits presented by these appeals is whether a transaction evidenced by a written "Lease Agreement and Purchase Option" executed

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[2] The judgments, as to amounts and periods for which recovery was allowed, were based upon agreements of the parties, and do not include any amount as refundable to William G. Elliot for 1946, or any amount as refundable to Thomas W. Elliot and his wife for 1946 or 1947. (No. 15983, R. 72, 87; No. 15984, R. 51.)

[3] The District Court's opinion (No. 15983, R. 73-79) was filed June 27, 1957, prior to the Supreme Court's decision in *United States* v. *Schaefer Brewing Co.*, 356 U.S. 227, and protective notices of appeal also were filed on behalf of the District Director on August 26, 1957 (No. 15983, R. 80; No. 15984, R. 53).

under date of January 14, 1946, supplemented by a Memorandum Agreement dated February 1, 1946, constituted a conditional sale of real property the gain from which may be reported on the installment basis for income tax purposes, as held by the District Court, or whether annual payments received under that contract represented rental income as reported by the taxpayers.

Before reaching the question on the merits, however, two preliminary questions should be resolved by this Court. Assuming arguendo, but without conceding, that the transaction constituted an installment sale of real property, the further questions presented on the record are:

1. Whether the taxpayers, having reported payments received under the contract as rental income, may later avail themselves of the installment provisions of the statute by filing refund claims and bringing suit on that basis for recovery of a part of the taxes paid.

2. Whether, as to some of the years involved, the District Court may entertain suits for recovery based on the ground that the taxpayers were entitled to have their taxes computed by the installment method whereas the refund claim for those years were based on the ground that gain from the alleged sale of property was taxable in the year of sale and no part of the payments received in subsequent years was taxable in the year of receipt.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the Internal Revenue Code of 1939 and Treasury Regulations involved are printed in the Appendix, *infra.*

STATEMENT

The facts material to a determination of the issues here involved were stipulated by the parties (No. 15983, R. 65-73; No. 15984, R. 45-53) or established by allegations and admissions in the pleadings (No. 15983, R. 3-12, 57-63; No. 15984, R. 3-12, 38-45), documentary evidence (No. 15983, R. 12-57) and oral testimony (R. 113-150).

Under date of January 14, 1946, the taxpayers, each as owner of an undivided one-half interest in a certain improved commercial property located in Kalispell, Montana, referred to in the record as the Buffalo Block, and F. A. Buttrey Company, a Montana corporation, executed an instrument in writing (No. 15983, R. 4-54) entitled "Lease Agreement and Purchase Option" with respect to that particular property which gives rise to the present income tax controversy. By its terms, that instrument is exactly what it is entitled, a lease agreement and purchase option, whereby the taxpayers, as owners and parties of the first part, leased to F. A. Buttrey Company, party of the second part, for a term of ten years beginning February 1, 1946, at an annual rental of $19,000 payable in advance, the property therein described, with an option to purchase the described property, but only during the last three months of the leasehold term except on conditions not here material, upon the giving of prior notice as therein provided and the payment of an additional amount of $75,000 in cash.

More specifically, the above "Lease Agreement and Purchase Option" provides in material part as follows (No. 15983, R. 42-44):

> Witnesseth:
>
> 1. That the said parties of the first part, for and in consideration of the rents, covenants and agreements herein mentioned and to be paid and performed by the said party of the second part, its successors and assigns, have demised, leased and let, and by these presents do demise, lease and let unto said party of the second part, its successors and assigns, the following described premises situated in the City of Kalispell, County of Flathead, State of Montana, to wit:
>
> * * * *
>
> To Have and To Hold the above described property unto the party of the second part, for and during the full term of ten (10) years beginning with the 1st day of February, 1946, and ending on the 31st day of January, 1956.
>
> 2. The party of the second part for itself, its successors and assigns, promises and agrees to pay to said first parties, their heirs, executors, administrators, or assigns, as rent for the above described property, the sum of Nineteen Thousand and No/100 Dollars ($19,000.00) per lease year, payable in cash in advance, the first year's rent to be paid at the time of the execution of this agreement, the receipt whereof is hereby acknowledged by the first parties, and that the rent for each succeeding year during the term

of this lease shall be paid by said second party on or before the first day of February of each year hereafter, and during the full period covered by this agreement.

3. It is expressly understood and agreed by and between the parties hereto that the party of the second part has viewed said premises and accepts them in their present condition, and that said second party will, at its own expense, keep said improvements in good repair during the term of this lease; and the party of the second part further covenants and agrees not to commit nor suffer any waste to be committed upon said premises, and that unless the option of purchase herein granted to the party of the second part is exercised as herein provided, said second party agrees to return said property and premises to the first parties at the end of the lease period herein provided, or the sooner termination thereof, in as good condition as it now is or may hereafter be put in by the party of the second part, reasonable wear and tear and damage by the elements alone excepted.

By paragraphs 4, 5, 6, 7, 8, 10, 11, and 14 of the "Lease Agreement and Purchase Option" (No. 15983, R. 44-48, 51-52), the lessee agreed to keep the building and improvements in good repair, maintain at least $175,000 insurance on the building, pay all state, county and city taxes assessed against the property and any improvements thereon, and fully maintain the property and furnish all fuel, light, power and water in connection with it use and occupancy; was given the right to assign or transfer the lease and to sublease, collecting such rentals as its own; was given the right to make alterations and improvements in and upon the premises, except that for major improvements or remodeling the taxpayers' consent in writing was to be obtained, and the right to use insurance benefits to make the property tenantable if damaged by fire. The expenses of any structural improvements to the building required by order of any public authority were to be borne by the taxpayers, and the taxpayers had the right of re-entry upon the abandonment of the property by the lessee.

Paragraphs 12 and 13 of the agreement provided as follows (No. 15983, R. 48-50):

> 12. As further consideration for this agreement, the party of the second part shall have and is hereby given the right and option to purchase said leased premises and property above described for the sum of Seventy-five Thousand and No/100 Dollars ($75,000.00) at any time during the three month period beginning with November 1st, 1955 and ended with January 31st, 1956. It is mutually understood and agreed by the parties hereto that said option of purchase can only be exercised during the three month period immediately above specified except under the acceleration provisions in paragraph 4 herein, and that said option may be exercised by said second party by giving either of said first parties notice in writing of said second party's intention to exercise said option, and by depositing with the Conrad National Bank of Kalispell at Kalispell, Montana, the said sum of $75,000.00 to the credit of said first parties. It is understood and agreed, however, that in lieu of such personal service of notice of intention to exercise said option, such notice may

be sent by registered mail addressed to either of the first parties at Kalispell, Montana, and that the date of depositing such notice by registered mail at Kalispell, Montana, addressed to either of said first parties, and the depositing of such funds in said bank, shall be deemed the date of the exercise of said option.

13. It is further understood and agreed by and between the parties hereto that at the time of the execution of this agreement, the parties of the first part shall likewise execute a good and sufficient Warranty Deed conveying the property hereinabove described to said second party, free and clear of liens and encumbrances, which deed, together with a copy of this agreement, shall be deposited in escrow with said Conrad National Bank of Kalispell with instructions to said Bank that said deed be delivered to the second party only if and when said second party exercises its option of purchase hereunder in keeping with the terms and conditions herein set forth. The parties of the first part covenant and agree that they are seized and possessed of title in fee to said premises and that they will furnish an Abstract of Title covering the real estate above described, prepared and certified to by a duly licensed abstractor in and for the State of Montana, which Abstract of Title shall be delivered to Messrs. Walchli and Korn, attorneys at law, Kalispell, Montana, on or before February 1st, 1946, for the purpose of examination of said title by said attorneys, with the understanding that upon the completion of said examination, said Abstract of Title shall be returned by said attorneys to said Bank and shall thereafter be held by it in escrow with said deed and a copy of this contract, as hereinabove provided. It is under-

stood and agreed that in the event the party of the second part shall fail to exercise said option of purchase as and within the time hereinabove specified, the said Conrad National Bank as such escrow agent shall have the right, and is hereby given the authority, to return said deed and abstract to the first parties, or either of them. It is further understood and agreed that if upon the examination of said abstract of title, it appears that the title is defective, but that such defect can be remedied, then, and in such event, the parties of the first part agree to immediately undertake and diligently prosecute the correction of any such defect at their expense. It is further agreed that any and all charges the said Conrad National Bank shall make as such escrow agent for its services hereunder shall be borne and paid for by the party of the second part.

Under date of February 1, 1946, the taxpayers and F. A. Buttrey Company executed a "Memorandum Agreement" (No. 15983, R. 54-57) reciting that "Whereas, the parties hereto have heretofore on the 14th day of January, 1946, entered into a written Lease Agreement covering" the described premises, and "Whereas, said Lease Agreement grants the above named second party the right and option to purchase all of the above described property for a stated consideration, provided such option is exercised by said second party on or between November 1, 1955, and January 31, 1956,"—

Now Therefore, it is mutually understood and agreed that the first parties shall, in contemplation of the exercise of said option by said second party, immediately deliver to the Conrad National Bank of Kalispell, Montana, the following papers:

1. An executed Warranty Deed coveying the above described property to the second party;

2. An abstract of title covering said property showing said first parties to be vested with a merchantable title, free and clear of encumbrances, as of the date of said Lease and Option Agreement, January 14, 1946;

the foregoing instrument to be held by said Bank in escrow and to be delivered by said Bank to the second party if and when said Option of Purchase is exercised in keeping with the terms thereof and proof of full payment by said second party under said Lease Agreement as of the time of the exercise of said option.

In the event said Option of Purchase is not exercised by the second party on or before January 31, 1956, the above mentioned papers shall be returned by said Bank to the first parties, their heirs or assigns.

The above agreements were carried out according to their terms, the Buttrey Company making the annual payments of $19,000 required thereunder to the taxpayer, and acquiring title to the property on November 5, 1955, upon exercise of its option and payment of the $75,000 as required by the agreement of January 14, 1946. (No. 15983, R. 86.)

In each of the years 1946 through 1953, both inclusive, William G. Elliot received $10,000 and Thomas W. Elliot received $9,000 as their respective shares of the $19,000 annual payments made by Buttrey Company under the above agreement. For the years 1946, 1947, 1948 and 1949 William G.

Elliot reported the $10,000 received by him each year as partnership income,[4] and for the years 1950, 1951, 1952 and 1953 he reported the amount each year as ordinary rental income. For all of the years 1946 through 1953, Thomas W. Elliot reported the $9,000 received by him in each year as ordinary rental income. (No. 15983, R. 71; No. 15984, R. 50.)

For the years 1946, 1947, 1948 and 1949 both taxpayers, and William G. Elliot for 1950 also, filed claims for refund of a portion of the income taxes paid by them for those years (No. 15983, R. 12-28, 30-33; No. 15984, R. 12-26), these refund claims all being based on the ground that the transaction evidenced by the "Lease Agreement and Purchase Option" and the Memorandum Agrement of February 1, 1946, constituted a conditional sale of the Buffalo Block property resulting in a capital gain which the taxpayers were entitled to report on the installment basis.[5] For the year 1949 both taxpayers filed a supplemental claim for refund (No. 15983, R. 29-30; No. 15984, R. 26-27), for the year 1950 William G. Elliot filed a second refund claim (No. 15983, R. 34-35), and for 1950, 1951, 1952 and 1953 Thomas W.

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[4] The evidence is not clear on this matter, and it is not of immediate importance, but apparently the Elliot brothers, George and Thomas, were partners in the business previously operated in the Buffalo Block and also in the operation of the building. (R. 113-123.)

[5] Computations attached to these refund claims (No. 15983, R. 14-17; No. 15984, R. 14-17) reflected a net gain of $226,356.73, of which one-half was taxable, with $4,270.88 being taxable to William G. Elliot for each of the years 1946 through 1955, and $3,843.80 being taxable to Thomas W. Elliot for each of those years.

Elliot (No. 15984, R. 28-35), and for 1951, 1952 and 1953 William G. Elliot (No. 15983, R. 36-41), filed refund claims, all of which latter claims demanded refund of all taxes paid by the respective taxpayers in each of those years on the ground that they had sold the property in Kalispell, Montana, to F. A. Buttrey Company in 1946 in a transaction which was completed in that year for income tax purposes, and that the payments received in subsequent years were not subject to tax in the year of receipt.

The complaints in both of these cases (No. 15983, R. 3-12; No. 15984, R. 3-12) seek recovery of only a portion of the tax paid for the years 1946 through 1953 on the ground that the transactions evidenced by the "Lease Agreement and Purchase Option" of January 14, 1946, and the Memorandum Agreement of February 1, 1946, constituted a sale of the property in question resulting in the realization of long term capital gain which they were entitled to report on the installment basis. The opinion, findings of fact and conclusions of law, and judgments in these cases No. 15983, R. 73-90; No. 15984, R. 54-55) are based on the grounds presented in the complaints, and the Director has appealed.

STATEMENT OF POINTS TO BE URGED

The basic record in each case contains a detailed statement of points to be urged by the Government. (See No. 15983, R. 101-103; No. 15984, R. 62-64.) Briefly, it is our position that the District Court erred—

1. In failing to hold, even assuming that taxpayers made a sale of their property to the Buttrey Com-

pany in 1946, that taxpayers did not elect to report the 1946 through 1953 payments to them by the Buttrey Company on the installment basis and are therefore precluded from recovering in these suits for refund on the theory that tax on the payments may now be computed on the installment basis.

2. In failing to hold, assuming that taxpayers made a sale of their property to the Buttrey Company in 1946, that, as to the years 1951 through 1953 as to taxpayer William G. Elliott and as to the years 1950 through 1953 as to taxpayer Thomas W. Elliott, there is a fatal variance between the complaints and the claims for refund on which they are based which precludes the tax refunds sought for those years.

3. In holding that the taxpayers made a sale of their property to the Buttrey Company in 1946 and that the payments received by taxpayers from the Buttrey Company in the years 1946 through 1953 were payments on the purchase price, instead of holding that the sale of the property did not occur until 1955, when the Buttrey Company exercised its option to purchase, and that the payments received in the prior years were rental income, as the taxpayers reported them on their returns.

SUMMARY OF ARGUMENT

1. The taxpayers are not entitled to recover in this case on the installment basis of reporting income for the years here involved, and the District Court erred in entering judgment for the taxpayers on that ground. The 1946 transaction which gives rise to this controversy resulted in the receipt of taxable

income by the taxpayers. For all years involved the taxpayers reported the amounts received annually as ordinary income from rents, without disclosing the nature of the 1946 transaction or making any election to have the income realized from the transaction taxed as capital gain from an installment sale of real property until refund claims for some years were filed on that basis beginning in March, 1951.

Assuming, but without admitting, that the 1946 transaction constituted a sale as alleged, rather than a lease agreement and purchase option as designated in the written instruments evidencing it, the taxpayers had the option under the law and the Regulations to report the gain from such sale either as gain from the sale of real property on the installment basis, if the transaction meets the requirements of the statute, or as a deferred payment sale of real property not on the installment basis. The taxation of such a sale as a deferred payment sale not on the installment basis, the gain being reported in the year of the sale, is in accord with the general principles of our federal income tax system that income is taxed on an annual basis and must be reported for the year in which it is received or accrues, unless under approved methods of accounting which clearly reflect the income it may be accounted for as of a different period. On the other hand, the installment method of reporting income from sales of property is a permissive method of reporting income which may be availed of by the taxpayer, if he qualifies under the statute, but which cannot be imposed upon him. It is settled that if the taxpayer makes a timely election to report income from a sale of real property according to either method by filing his return for the year of the sale on that basis such election is binding both on the taxpayer and the Commissioner for that and subsequent years. The position of the Internal Revenue Service and the weight of authority is that the taxpayer may make a timely election to have income reported according to the installment method only by filing a timely return on that basis for the year of the sale; otherwise gain must be taxed according to general principles as income for the year of the sale. We submit that principle is applicable where, as here, the taxpayer fails to make an affirmative election in his return for the year of the alleged sale to have gain taxed on either basis, but merely reported amounts received as ordinary income without disclosing the nature of the transaction under which they were received.

2. It is settled law that the United States may be sued only with its consent and then only on such conditions and subject to such limitations as the Congress may impose. It is equally well settled that in the cases of federal taxes paid, a suit for refund thereof must be based on a timely filed refund claim, and that recovery can be had only on grounds set forth in the refund claim on which the suit is based. The courts of the United States may not grant a refund on grounds so completely at variance with grounds set forth in the refund claim as did the District Court in the instant case with respect to the years 1951 to 1953, inclusive, in the case of William G. Elliot, and the years 1950 to 1953, inclusive, in the case of Thomas W. Elliot. As to these

later years the refund claims were based on the ground that a completed sale of the taxpayer's property had occurred in 1946, no part of the gain on which was taxable in later years, while both the complaints and the judgment of the District Court were based on the ground that the agreements entered into in 1946 constituted a sale of real property in that year at a substantial gain which was taxable on the installment basis for the years in which payments were received. Even assuming a sale of the property in issue occurred in 1946, with which we do not agree, the District Court erred as to these later years in entering judgment for the taxpayers on a ground not set forth in the refund claims filed for those years.

3. Finally, recovery by taxpayers is precluded by their failure to establish that the "Lease Agreement and Purchase Option" was, instead of that, a present sale of the property in 1946. The parties' agreement was for the payment of "rent" by the Buttrey Company for a 10-year period and gave the Company, as lessee, an option to purchase the property at the end of that period for $75,000, a substantial sum. A warranty deed to the property was to be delivered to the lessee only if it exercised its option to purchase. The lessee therefore acquired no equity in the property. Under the decisions of this Court, the agreement itself is the primary evidence of the parties' intent and the other evidence in the case, while it reflects that taxpayers thought they were selling the property, does not show that they thought they were making a present sale in 1946, as distinguished from a sale at the end of the lease period.

ARGUMENT

As to all of the taxable years here involved[6] the taxpayers reported in their income tax returns, as ordinary income from rents, their proportionate shares of the annual payments received by them under the above "Lease Agreement and Purchase Option". The only ground for recovery alleged in the complaints filed herein (No. 15983, R. 3-12; No. 15984, R. 3-12) is that the transaction evidenced by that agreement and the memorandum agreement of February 1, 1946, constituted a sale of the described property in that year resulting in a long term capital gain which should be taxed on the installment basis.[7] Taxpayers of course are not entitled to recover if the payments they received from the Buttrey Company in 1946 through 1953 were rental income (as they reported the payments in their returns), instead of payments on the purchase price of property sold in 1946. But in the District Court the Government also interposed two other defenses, which were not explained too clearly but were rejected or disregarded by the District Court. (See No. 15983, R. 74-75; Finding 18, R. 87--88; Conclusion of Law 4, R. 88.) These two defenses have reference to denial of recovery even

[6] The judgments of the District Court (No. 15983, R. 89-90; No. 15984, R. 54-55) do not include any refund for 1946 in the case of William G. Elliot because the refund claim was not timely; or any refund for 1946 or 1947 in the case of Thomas W. Elliot, presumably because the complaint was not timely filed as to those years.

[7] This also was the ground set forth in refund claims filed by William G. Elliot for 1946 through 1950, inclusive, and by Thomas W. Elliot for 1946 through 1949, inclusive.

assuming that a sale of the property occurred in 1946 (instead of 1955). The first defense—that taxpayers cannot recover on the theory of a sale reportable on the installment basis, because they did not elect in their 1946 return to report the proceeds on the installment basis—applies to all of the taxable years in suit (1946 through 1953). The other defense—a fatal variance between the claims for refund and the basis for recovery alleged in the complaints—applies to the years 1951 through 1953 as to taxpayer William G. Elliot and as to the years 1950 through 1953 as to taxpayer Thomas W. Elliot. Since the question whether a sale of the property occurred in 1946 (instead of 1955) need not in our opinion be reached, we shall discuss these latter two defenses first.

I

Taxpayers, Having Failed To Report Their Income On That Basis, May Not Now Avail Themselves Of The Benefit Of The Installment Sales Provisions Of Section 44 Of The Internal Revenue Code Of 1939

As just indicated, one of the defenses urged below by the Director was that, as to all years involved, even assuming the 1946 transaction constituted a sale of the taxpayers' property rather than a lease and purchase option, the taxpayers are not entitled to recover on the ground alleged in their complaints because they had failed to make a timely election to have the income therefrom taxed on the installment basis. In failing to so hold, we submit the District Court was in error as a matter of law.

Section 22(a) of the 1939 Code (Appendix, *infra*) defines gross income as including, among other things, all income from "sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rents, * * * or gains or profits and income derived from any source whatever". Section 42 of the 1939 Code (Appendix, *infra*), and the corresponding provisions of prior Revenue Acts on which it was based, requires that as a general rule the amount of all items of gross income shall be reported as income for the year in which received by the taxpayer, unless, under methods of accounting permitted by Section 41 of the 1939 Code, any such amounts are to be properly accounted for as of a different period. Section 41 (Appendix, *infra*) provides that the net income shall be computed on the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of the taxpayer, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income.

However, statutory provision has been made for special or preferred treatment for tax purposes of specified categories of income, such as capital gains, gains from installment sales of property, etc. Generally speaking, such statutory exceptions to the general rule are intended for the benefit of the taxpayer, and not only are they strictly construed, but the taxpayer has the burden of bringing himself squarely within the terms of such provisions. Moreover, in many instances the taxpayer is required to affirmatively indicate his election to avail himself of the benefit of such statutory provisions, usually with the filing of his return.

The statutory provision with which we are presently concerned is Section 44(b) of the Internal Revenue Code of 1939 (Appendix, *infra*), which, so far as pertinent here, provides that, in the case of a sale or other disposition of real property, if the initial payments do not exceed 30% of the selling price, "the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed" in subsection (a) of that section. Subsection (a) (Appendix, *infra*), which applies to dealers in personal property, provides that under Regulations prescribed by the Commissioner a person who regularly sells or otherwise disposes of personal property on the installment plan "may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price".[8]

Statutory recognition of the installment method of reporting income first appeared in Section 212(d) of the Revenue Act of 1926, c. 27, 44 Stat. 9, because

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[8] See Treasury Regulations 111, Sections 29.44-2, 29.44-3, and 29.44-4 (Appendix, *infra*), promulgated pursuant to Section 44 of the 1939 Code.

of doubt which had arisen as to the Commissioner's authority to permit, by regulation, such method of reporting income.[9] The installment method has always been regarded as a *permissive* method of reporting income, available to the taxpayer at his election if he is qualified under the statute to avail himself of it, but it may not be imposed upon him by the Commissioner. *Viault* v. *Commissioner*, 36 B.T.A. 430, 431-432. Compare *Louis Werner Saw Mill Co.* v. *Helvering*, 96 F. 2d 539 (C.A. D.C.), second appeal dismissed, 102 F. 2d 994 (C.A. 8th). Neither the statute nor the Regulations promulgated thereunder [10] spell out the time or manner in which a taxpayer may exercise his election to have the income from an installment sale of real property taxed in accordance with Section 44 of the 1939 Code. However, it is clear from the language of Section 44, when read in connection with the provisions of Sections 41 and 42 of the 1939 Code, and from the many decisions dealing with the subject, that a taxpayer can avail himself of the benefit of the installment method of reporting income only by making a timely and affirmative election to have the income taxed on that basis.

As illustrated by the Regulations,[11] sales of real

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[9] See S. Rep. No. 52, 69th Cong., 1st Sess., p. 19 (1926) (1939-1 Cum. Bull. (Part 2) 332, 346-347); 2 Mertens, Law of Federal Income Taxation, Sec. 15.02, p. 447.

[10] See Treasury Regulations 111, Sections 29.44-2, 29.44-3, 29.44-4.

[11] Treasury Regulations 111, Sections 29.44-2, 29.44-3, and 29.44-4.

property involving deferred payments fall into two classes, i.e., (1) sales which qualify as installment sales for purposes of the statute, and (2) deferred payment sales which do not qualify as installment sales. As to the latter class, income, of necessity, is taxed in the year of sale, computed in accordance with Section 29.44-4 of Regulations 111 (Appendix, *infra*). As to the former, Section 29.44-3 of the Regulations (Appendix, *infra*) provides that the vendor "may" return as income from such transactions in any taxable year "that proportion of the installment payments actually received in that year which the total profit realized or to be realized when the property is paid for bears to the total contract price." However, "If the vendor chooses as a matter of consistent practice to return the income from installment sales on the straight accrual or cash receipts and disbursements basis, such course is permissible, and the sales will be treated as deferred-payment sales not on the installment basis."

It is the position of the Internal Revenue Service, as expressed in Rev. Rul. 93, 1953-1 Cum. Bull. 82, and amplified by Rev. Rul. 56-396, 1956-2 Cum. Bull. 298, that the appropriate method of making a timely election to have income from such transactions taxed on the installment basis is to file a timely return on that basis for the year in which the transaction takes place, and the decisions generally are in accord with this position. E.g., see *Pacific National Co.*, v. *Welch*, 304 U.S. 191, and cases cited, fn. p. 195; *United States* v. *Kaplan*, 304 U.S. 195; *Commissioner* v. *Moore*, 48 F. 2d 526 (C.A. 10th), certiorari denied, 284 U.S. 620; *Walker* v. *Commissioner*, 63 F. 2d 346

(C.A. 5th), rehearing denied, 65 F. 2d 97 (C.A. 5th), certiorari denied, 290 U.S. 651; *Howbert* v. *Norris*, 72 F. 2d 753 (C.A. 10th); *Livermore* v. *Miller*, 94 F. 2d 111 (C.A. 5th), certiorari denied, 304 U.S. 582; *Louis Werner Saw Mill Co.* v. *Helvering*, 96 F. 2d 539 (C.A. D.C.), second appeal dismissed, 102 F. 2d 994 (C.A. 8th); *Marks* v. *United States*, 98 F. 2d 564 (C.A. 2d), certiorari denied, 305 U.S. 652; *Commissioner* v. *Saunders*, 131 F. 2d 571 (C.A. 5th), certiorari dismissed, 318 U.S. 796; *Jacobs* v. *Commissioner*, 224 F. 2d 412 (C.A. 9th); *Coffin* v. *United States*, 120 F. Supp. 9 (S.D. Ala.); *Frost* v. *Commissioner*, 37 B.T.A. 190; *Thrift* v. *Commissioner*, 15 T.C. 366; *Cedar Valley Distillery, Inc.* v. *Commissioner*, 16 T.C. 870; *Vischia* v. *Commissioner*, 26 T.C. 1027, and numerous others involving analogous situations.

The above decisions, especially *Pacific National Co.* v. *Welch*, *supra*, and *United States* v. *Kaplan*, *supra*, make it clear that the filing of a timely return for the year in which the sale occurs, in which the income from the sale is reported either as an installment sale if it otherwise qualifies as such under the statute, or as a deferred payment sale not on the installment basis, constitutes an election by the taxpayer to have the income taxed on that basis which is binding both on the taxpayer and the Commissioner. More than that, they support the position of the Internal Revenue Service [12] that if the taxpayer fails to elect the installment method of reporting income in a timely return for the year of sale he has forfeited his right

[12] Rev. Rul. 56-396, 1956-2 Cum Bull. 298.

of election. For instance, in *Briarly* v. *Commissioner*, 29 B.T.A. 256, cited with approval in *Pacific National Co.* v. *Welch*, *supra*, p. 195, fn., where returns were not filed by the taxpayers for the year of sale but were prepared by the Collector at a later date, gain from the sale of property being treated as gain from a deferred payment sale not on the installment basis, it was held that the taxpayers, while they may have elected to return the gain on the installment basis, had forfeited their right to do so by failing to file a timely return on that basis. And where a return is filed for the year of sale but income from the sale is not reported on either basis, it is generally held that the taxpayer has lost the right to have such income taxed on the installment basis. E.g., *Howbert* v. *Norris*, *supra*; *Livermore* v. *Miller*, *supra*; *Louis Werner Saw Mill Co.* v. *Helvering*, *supra*; *Frost* v. *Commissioner*, *supra*; *Cedar Valley Distillery, Inc.* v. *Commissioner*, *supra*.

The appropriateness of requiring the taxpayer to make an affirmative election in a timely return for the year of sale to have income taxed on the installment basis, instead of having his tax computed according to general principles, is emphasized by the general requirements of Sections 41 and 42 of the 1939 Code, to which Section 44 is an exception, and the underlying principle of our tax system that income is to be accounted for on an annual basis. Aside from the equitable considerations involved,[13] it is most

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[13] Compare *Commissioner* v. *Moore*, *supra*, and *Marks* v. *United States*, 18 F. Supp. 911, 91B (S.D. N.Y.), affirmed, 98 F. 2d 564 (C.A. 2d), certiorari denied, 305 U.S. 652, both cited with approval in *Pacific National Co.* v. *Welch*, *supra*,

essential, both from an administrative standpoint and for the protection of the revenue, that the taxpayer make an affirmative election in his original return for the year of the sale or else be taxed in accordance with the principles governing taxation of income generally.[14]

As the Supreme Court said in *Pacific National Co.* v. *Welch*, *supra* (pp. 194-195):

> The parties agreed that, if allowed to change to the installment method, petitioner would be entitled to a refund in some amount. But that fact has no tendency to discredit the deferred payment method as inapplicable. The amount of the tax for the year in question is only one of

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fn. p. 195; also, *Walker* v. *Commissioner*, 63 F. 2d 346 (C.A. 5th), rehearing denied, 65 F. 2d 97 (C.A. 5th), certiorari denied, 290 U.S. 651; *Howbert* v. *Norris*, 72 F. 2d 753 (C.A. 10th); *Livermore* v. *Miller*, 94 F. 2d 111 (C.A. 5th), certiorari denied, 304 U.S. 582; *Louis Werner Saw Mill Co.* v. *Helvering*, 96 F. 2d 539 (C.A.D.C.), second appeal dismissed, 102 F. 2d 994 (C.A. 8th); *Saunders* v. *United States*, 101 F. 2d 133 (C.A. 5th).

[14] The necessity for such election was recognized by Congress in enacting Section 705 of the Revenue Act of 1928, c. 852, 45 Stat. 791, relating to retroactive application of the installment method where a taxpayer had "by an *original return* * * * changed the method of reporting his net income * * * to the installment basis * * *." [Italics supplied.] As the House Bill (H.R.1, 70th Cong., 1st Sess.) passed the Senate, Section 705(a) read: "If any taxpayer by a return or an amended return * * *", but was amended in conference to read as above. See H. Conference Rep. No. 1882, 70th Cong., 1st Sess., p. 7 (1928) (1939-1 Cum Bull. (Part 2) 444, 445); also, H. Rep. No. 2, 70th Cong., 1st Sess., pp. 14-15 (1927) (1939-1 Cum. Bull. (Part 2) 384, 393-394); S. Rep. No. 960, 70th Cong., 1st Sess., pp. 22-24 (1928) (1939-1 Cum Bull. (Part 2) 409, 424-426).

> many considerations that may be taken into account by the taxpayer when deciding which method to employ. The one that will produce a higher tax may be preferable because of probable effect on amount of taxes in later years. In case of overstatement and overpayment, the taxpayer may obtain refund calculated according to the method on which the return was made. Change from one method to the other, as petitioner seeks, would require recomputation and readjustment of tax liability for subsequent years and impose burdensome uncertainties upon the administration of the revenue laws. It would operate to enlarge the statutory period for filing returns (§ 53 (a)) to include the period allowed for recovering overpayments (§ 322 (b)). There is nothing to suggest that Congress intended to permit a taxpayer, after expiration of the time within which return is to be made, to have his tax liability computed and settled according to the other method. By reporting income from the sales in question according to the deferred payment method, petitioner made an election that is binding upon it and the commissioner.

See, also, the decision of this Court in *Jacobs* v. *Commissioner*, 224 F. 2d 412.

One aspect of the administrative difficulties which may be encountered from failure to require a timely and affirmative election by the taxpayer to report income from a sale of real property on the installment basis, when that method is applicable, and also a sound legal basis for reversing the decision of the District Court herein, is demonstrated by the facts of this case. Here, the taxpayers filed their income tax returns for 1946, the year of the alleged sale, and for all succeeding years involved, without making any disclosure concerning the 1946 transaction in any of their returns. Apparently the first disclosure made to the Commissioner of anything relating to this transaction was made with the filing of their first refund claims (for 1946) in March, 1951, at a time when the Commissioner was barred by the statute of limitations [15] from assessing any additional tax for that year had he been so inclined. After filing refund claims for 1946 the taxpayers continued to file returns reporting payments received under the 1946 agreement as rental income, and continued to file refund claims on the installment basis for each year prior to expiration of the statute of limitations for such year until William G. Elliot had filed refund claims on that basis for the years 1946 through 1950 and Thomas W. Elliot had filed claims on that basis for all years 1946 through 1949. Thereafter, apparently abandoning the installment basis for seeking refunds, both taxpayers filed refund claims, supplemental or second claims, for the full amount of taxes paid for the years 1949 through 1953—earlier years then being barred by the statute of limitations—on the ground that all gain from the alleged sale was taxable in 1946. It was not until the complaints were filed in the court below that the taxpayers took a definite position that income from the alleged 1946 sale of property was taxable on the installment basis in the years the payments under the "Lease Agreement and Purchase Option" of January 14, 1946,

[15] Section 275(a) of the Internal Revenue Code of 1939.

were received. Furthermore, under the concumstances disclosed by the record, it is only reasonable to assume that the Buttrey Company, rather than treating the payments involved as annual payments on the purchase price of property, was claiming and being allowed the amount of these payments as deductible business expenses (rent) on its income tax returns.

In the situation disclosed by the record in these cases we submit that, assuming a sale of the property involved in 1946, the taxpayers have failed to establish any basis for recovery for any year covered by their complaints on the ground that the gain realized on that sale should be taxed on the installment basis in the years the payments in issue were received, and the District Court erred in failing to so hold.

Taxpayers no doubt will rely upon the decision in *Scales* v. *Commissioner*, 211 F. 2d 133, a case involving a somewhat analogous situation so far as this election issue is concerned, in which the Court of Appeals for the Sixth Circuit reversed the decision of the Tax Court, reported at 18 T.C. 1263, and held that the taxpayer was entitled in a deficiency proceeding before the Tax Court to have his income for the year of the sale taxed on the installment basis although he had reported it as rental income. Without going into too much detail, the taxpayer in that case sold a dairy farm, including improvements and personal property thereon, in 1943, the transaction being evidenced by several written instruments, including an agreement couched in terms of a lease-sale undertaking intended for the benefit of the seller in case of default by the purchaser, and two interest bearing promissory notes, one for the price of the land and improvements and one for the price of the personal property, payable in monthly installments over a period of five years, with no initial down payment. In his 1943 return the taxpayer reported as rental income the amount of the monthly payments received in that year without disclosing any information regarding the agreement under which the payments were received. In asserting a deficiency for that year the Commissioner, among other things, held that the transaction constituted a sale in 1943 and treated as a capital gain for that year the profit realized on the transaction. The taxpayers then raised the issue in the Tax Court whether such gain was taxable on the installment basis. The Tax Court rejected this contention, primarily on the ground that the taxpayer had not made a timely election to have its income from the sale taxed on the installment basis. The Court of Appeals, without any serious explanation of its reason for doing so, held on the authority of its earlier decision in *United States* v. *Eversman*, 133 F. 2d 261, that the taxpayer was entitled to have his gain for the year of sale computed on the installment basis. A most superficial examination of the facts in the *Eversman* case, *supra*, will show that it is clearly distinguishable from the instant case. Moreover, as this Court felt in *Jacobs* v. *Commissioner*, 224 F. 2d 412, 414, if the case of *Scales* v. *Commissioner*, *supra*, is not distinguishable, we cannot agree with it. It should be noted, however, that the *Scales* case dealt only with the year of sale, rather than also with a long period of time following the year of sale in which the taxpayers continued to report the rental payments as such; that it was a proceeding before the Tax Court for redetermination of deficiency for the year of sale rather than a suit for refund where the burden of proof is more exacting; and that this case, at least, it not one merely of "failure of the taxpayer 'to adopt fruitless ritualistic measures'" (211 F. 2d 134), as clearly shown by the amount of the judgments entered by the District Court. Moreover, while the court may have been technically correct in its statement in the *Scales* case, *supra*, that the taxpayer reported as rent "the same amount as would have been reported as payments from an installment sale" (p. 134), the statement implies a misunderstanding because the land and improvements sold there had a substantial cost basis which would reduce the amount of gain reportable—most of which was a capital gain rather than ordinary income. Moreover, the decision in the *Scales* case fails to take into consideration the necessity for the taxpayer to make a timely election have his profit from an installment sale taxed under Section 44(b) if it is not to be taxed in accordance with Sections 41 and 42 of the 1939 Code.

We submit that on the basis of the foregoing authorities an affirmative and timely election to that effect is necessary if a taxpayer is to have income from the sale of real property taxed on the installment basis, and that in the instant case no such timely election was made. Contrary to the District Court's finding and holding (No. 15983, R. 88), there *is* a "procedural or substantive rule of law which prohibits the making of these refunds". Accordingly, the District Court erred in entering judgment for the taxpayers on the installment basis and its judgment should be reversed.

II

The District Court Erred In Any Event In Entering Judgment For The Taxpayers On The Basis Of Installment Taxation Of Income For Those Years In Which Refunds Were Claimed On The Basis That Income From The 1946 Transaction Had Been Erroneously Reported For The Later Years

In addition to the contention, discussed above, that the taxpayers may not recover for any of the years involved in these suits because they did not make a timely election to have their alleged capital gain taxed on the installment basis, the Government further contended before the iDstrict Court (No. 15983, R. 74-75) that as to the years 1951, 1952 and 1953 in the case of William G. Elliot and as to the years 1950, 1951, 1952 and 1953 in the case of Thomas W. Elliot, even assuming that a sale of the property in question occurred in 1946 as claimed, the taxpayers may not recover in any event because their complaints were not based on grounds set forth in their refund claims for those years.

As pointed out above, the complaints as to all years involved in these suits were based on the ground that the 1946 transaction in issue constituted an installment sale of the taxpayers' real property in that year, the income from which was taxable on the installment basis in the years in which payments were received. Actually, this statement was of necessity based on the refund claims first filed by the taxpayers,[16] the facts alleged in their complaints (No. 15983, R. 3-12; No. 15984, R. 3-12) and the amount of recovery sought by the prayer of the respective complaints. The refund claims clearly were based upon the ground that the property in issue allegedly was sold for $265,000, payable $19,000 a year plus a final payment of $75,000, resulting in a capital gain of $226,356.73 which was reportable on the installment basis as payments were received, and the prayer of the complaints as to the years covered by refund claims for these earlier years is for the amounts, with interest, set forth in the refund claims filed for those years, although as to all years the complaints merely allege that as to the 1946 transaction "The transfer set forth in paragraph (22) above resulted in a long term capital gain under Section 117 of the Internal Revenue Code of 1939". (No. 15983, R. 11; No. 15984, R. 11.) For the later years here under discussion, the refund claims filed by the taxpayers (No. 15983, R. 36-41; No. 15984, R. 28-35) were for the full amount of the tax paid for such year, and were based on the alleged ground that the taxpayers had erroneously reported their respective shares of the yearly payment under the 1946 agreement as rental income and paid the tax thereon at ordinary income tax rates whereas, under the law, "a completed sale occurred in 1946 resulting in a long term capital gain" (No. 15983, R. 37, 39, 41; No.

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[16] For the years 1946 through 1950 by William G. Elliot (No. 15983, R. 12-28, 32-33) and for the years 1946 through 1949 by Thomas W. Elliot (No. 15984, R. 12-26).

15984, R. 29, 31, 33, 35).[17] However, the prayers of the complaints were for a lesser amount than the full tax paid for each year, apparently computed on the basis of taxing a proportionate amount of the payment received each year as long term capital gain. Moreover, this variance is emphasized by the so-called supplemental claim filed by each taxpayer for 1949 setting out the new ground for refund in which appears the statement that (No. 15983, R. 29-30; No. 15984, R. 27)—

> The original refund claim previously filed claimed capital gain treatment on payments received from certain property, using the installment basis method of computing gain on the transaction.
>
> This claim is filed to claim the right to exclude all payment received during 1949 on this transaction on the grounds that a sale occurred in 1946 and that payments received in subsequent years are not income.

That an action will not lie for a refund of taxes where the complaint is based on a grounds entirely different from the grounds set forth in the refund claim on which it is based is so well settled that discussion or citation of authority to demonstrate the District Court's error in entering judgment with respect to the later years enumerated above seems superfluous. Reference to this Court's decision in

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[17] In fact, it is not clear that the complaints can reasonably be said to be based on the same grounds as the earlier refund claims because they contain no allegation that the gain from the 1946 sale is taxable on the installment basis—or at any other time or in any other manner, for that matter.

Daley v. *United States*, 243 F. 2d 466, certiorari denied, 355 U.S. 832, and the decision of the Court of Appeals for the Second Circuit in *Marks* v. *United States*, 98 F. 2d 564, certiorari denied, 305 U.S. 652, would seem to be sufficient. In fact, the problem in the instant cases so far as this issue is concerned, even assuming a sale occurred in 1946, seems to be indistinguishable from that involved in the *Marks* case, *supra*. See, also, *B. F. Goodrich Co.* v. *United States*, 135 F. 2d 456, 460-461 (C.A. 9th), affirmed on another ground, 321 U.S. 126; *French* v. *Smyth*, 110 F. Supp. 195 (N.D. Calif.), affirmed by this Court without opinion *sub nom.*, *French* v. *Berliner*, 218 F. 2d 351, and cases cited; *Carmack* v. *Scofield*, 201 F. 2d 360 (C.A. 5th), certiorari denied, 340 U.S. 875. Compare *Real Estate Title Co.* v. *United States*, 309 U.S. 13, 16-17; *Rogan* v. *Ferry*, 154 F. 2d 974 (C.A. 9th); *Vica Co.* v. *Commissioner*, 159 F. 2d 148 (C.A. 9th). In *Rogan* v. *Ferry*, *supra*, this Court most appropriately observed that (p. 976)—

> It is of course the law that a suit for refund of taxes must be based on a claim previously filed with the Commissioner, and that the claim must set forth in detail each ground on which a refund is claimed and facts sufficient to apprise the Commissioner of the exact basis thereof.

As this Court is fully advised, it long has been settled that the Government can be sued only with its consent and only upon such conditions and subject to such limitations as the Congress may impose. It is equally well settled that the courts of the United States can entertain an action for refund of taxes paid, whether the action is brought nominally against the Collector or directly against the United States, only when the action is based upon specific grounds set forth in a timely claim for refund. In addition to the cases cited above, see *United States* v. *Felt & Tarrant Co.*, 284 U.S. 269; *United States* v. *Memphis Cotton Oil Co.*, 288 U.S. 62; *United States* v. *Henry Prentiss & Co.*, 288 U.S. 73; *United States* v. *Factors & Finance Co.*, 288 U.S. 89; *Bemis Bro. Bag Co.* v. *United States*, 289 U.S. 28; *United States* v. *Andrews*, 302 U.S. 517; *United States* v. *Garbutt Oil Co.*, 302 U.S. 528; *Angelus Milling Co.* v. *Commissioner*, 325 U.S. 293. The decisions in *United States* v. *Andrews*, *supra*, and *United States* v. *Garbutt Oil*, *supra*, make it eminently clear that the taxpayer may not, as these taxpayers did in the court below, recover in a suit based upon a ground so unrelated to the ground set forth in the refund claim on which it was based. Clearly, for the years 1951 through 1953 as to William G. Elliot and the years 1950 through 1953 as to Thomas W. Elliot, the District Court was in error, as a matter of law, in finding (No. 15983, R. 87-88) that "there is no fatal variance between the refund claims * * * and the complaints filed herein and that there is no procedural or substantive rule of law which prohibits the making of these refunds."

III

No Sale Of The Property To Buttrey Company Occurred In 1946; The Amounts Received By Taxpayers During The Years 1946 Through 1953 Were Rental Income

The District Court found as a fact that "it has been conclusively established that" taxpayers "did, in fact, make a sale of their property to Buttrey Co. [in 1946] * * * and that the yearly rentals, so called, were installment payments on the purchase price * * *." (No. 15983, R. 86.) But the question whether there was a sale in 1946, or a lease until the option to purchase was exercised, as we contend, is *not* one of pure fact; it is at least a mixed question of law and fact, as this Court has plainly indicated. *Oesterreich* v. *Commissioner*, 226 F. 2d 798 (C.A. 9th); *Commissioner* v. *Wilshire Holding Corp.*, 244 F. 2d 904 (C.A. 9th), certiorari denied, 355 U.S. 815, rehearing denied, 355 U.S. 879; *Haggard* v. *Commissioner*, 241 F. 2d 288 (C.A. 9th); *Benton* v. *Commissioner*, 197 F. 2d 745 (C.A. 5th); see also, *Breece Veneer & Panel Co.* v. *Commissioner*, 232 F. 2d 319 (C.A. 7th). As the Court stated in its *Oesterreich* opinion, *supra*, p. 803, "The intention of the parties, as expressed in the instrument, was cardinal * * *. No question of fact was involved".

Here, looking to the instrument involved, as well as the other evidence bearing on the parties' intent, the instrument (Ex. K, No. 15983, R. 41-52) was exactly what it purported to be—a "Lease Agreement and Purchase Option". This case is not like *Oesterreich*, where the lessee was to acquire title to the property at the end of the lease term for a nominal amount ($10), there was no question that the purchase option would be exercised, and the lessee acquired an equity in the property. Here, where the instrument provided for a 10-year period for payment of "rent" (No. 15983, R. 43), the option was to purchase the property at a substantial price, $75,000, and a warranty deed to the property, held in escrow (No. 15983, R. 54-56), was to be delivered to the lessee "only if and when said second party exercises its option of purchase hereunder in keeping with the terms and conditions herein set forth" (No. 15983, R. 49). The Buttrey Company therefore acquired no equity in the property until the purchase option was exercised. *Helvering* v. *San Joaquin Co.*, 297 U.S. 496, 498, 500. Moreover, the "rent", $19,000 "per lease year" (No. 15983, R. 43), could not have been substantially more than the rental value of the property, except for the lessee's obligation to pay maintenance expenses (perhaps about $9,500 a year, see No. 15983, R. 83-84), for in the 1945 negotiations for straight rental with*out* a purchase option, the lessee had agreed to pay what amounted to a total rental of $1,200 a month, or $14,400 a year, for only the first floor of the building (R. 123), as the District Court found (see No. 15983, R. 84), and, as the District Court further found (*id.*, R. 83), taxpayers "also collected some rentals from the office space on the second story".

While the District Court found as a fact that "it was so understood by both parties" that a sale was made in 1946 (No. 15983, R. 86), that finding is not supported by either the "Lease Agreement and Purchase Option" or by the other evidence. Some significance, so far as the parties' intent is concerned, must be attached to the fact that the parties called the transaction a "Lease Agreement and Purchase Option" and made provision for the payment of "rent" by the Buttrey Company, although, as the Court held in the *Oesterreich* case, the nomenclature is not controlling. It is also significant that both taxpayers reported the payments by the Buttrey Company for the taxable years as rental income. Taxpayer Thomas W. Elliot apparently thought he was selling the property (see R. 124, 134, 142-143) and, indeed, his nephew (the son of taxpayer William G. Elliot, R. 139-140), had advised him to sell (R. 142). But there is no evidence that Thomas W. Elliot thought he was selling the property as of 1946, instead of at the end of the lease period. He testified that he read the lease agreement and purchase option before signing it (R. 125), made no suggestion or request for any change in the instrument (R. 126), and did not concern himself with its legal effect (R. 127). He also testified that the yearly payments by the Buttrey Company were reported as rental income in returns made out for taxpayers by a bookkeeper (R. 129-131) to whom he turned over what he called "the rental receipts and records" (R. 130). Apparently it was not until later, when his nephew advised him that the Buttrey Company had taken advantage of them taxwise (see R. 144), that he gave any thought to treating the lease agreement and purchase option as effecting a sale *in 1946*.

In point of fact and law, with the "Lease Agreement and Purchase Option" the "cardinal" criteria (*Oesterreich* v. *Commissioner*, *supra*, p. 803), there was no present sale of the property in 1946. Cf. *Benton* v. *Commissioner*, *supra*. The payments received from the Buttrey Company by taxpayers during the years 1946 through 1953 were rental income, as they reported it in their returns.

It should be noted that in these suits for refund taxpayers had the burden of proof. *Lewis* v. *Reynolds*, 284 U.S. 281. They have failed to sustain their burden of proving that their "Lease Agreement and Purchase Option" was, instead of that, a present sale of the property in 1946.

CONCLUSION

For the reasons stated, the judgment of the District Court should be reversed.

Respectfully submitted,

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APPENDIX

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * *

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(26 U.S.C. 1952 ed., Sec. 41.)

SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

(26 U.S.C. 1952 ed., Sec. 42.)

SEC. 44. INSTALLMENT BASIS.

(a) *Dealers in Personal Property.*—Under regulations prescribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price.

(b) *Sales of Realty and Casual Sales of Personality.*—In the case (1) of a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year), for a price exceeding $1,000, or (2) of a sale or other disposition of real property, if in either case the initial payments do not exceed 30 per centum of the selling price (or, in case the sale or other disposition was in a taxable year beginning prior to January 1, 1934, the percentage of the selling price prescribed in the law applicable to such year), the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this section. As used in this section the term "initial payments" means the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made.

* * * *

(26 U.S.C. 1952 ed., Sec. 44.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.44-2. *Sale of Real Property Involving Deferred Payments.*—Under section 44 deferred-payment sales of real property include (a) agreements of purchase and sale which contemplate that a conveyance is not to be made at the outset, but only after all or a substantial portion of the selling price has been paid, and (b) sales in which there is an immediate transfer of title, the vendor being protected by a mortgage or other lien as to deferred payments. Such sales, either under (a) or (b), fall into two classes when considered with respect to the terms of sale, as follows:

(1) Sales of property on the installment plan, that is, sales in which the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable year in which the sale is made do no exceed 30 percent of the selling price;

(2) Deferred-payment sales not on the installment plan, that is, sales in which the payments received in cash or property other

than evidences of indebtedness of the purchaser during the taxable year in which the sale is made exceed 30 percent of the selling price.

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Sec. 29.44-3. *Sale of Real Property on Installment Plan.*—In transactions included in class (1) in section 29.44-2 the vendor may return as income from such transactions in any taxable year that proportion of the installment payments actually received in that year which the total profit realized or to be realized when the property is paid for bears to the total contract price.

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If the vendor chooses as a matter of consistent practice to return the income from installment sales on the straight accrual or cash receipts and disbursements basis, such a course is permissible, and the sales will be treated as deferred-payment sales not on the installment plan.

Sec. 29.44-4. *Deferred-Payment Sale of Real Property Not on Installment Plan.*—In transactions included in class (2) in section 29.44-2, the obligations of the purchaser received by the vendor are to be considered as the equivalent of cash to the amount of their fair market value in ascertaining the profit or loss from the transaction.

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If the obligations received by the vendor have no fair market value, the payments in cash or other property having a fair market value shall be applied against and reduce the basis of the property sold, and, if in excess of such basis, shall be taxable to the extent of the excess. Gain or loss is realized when the obligations are disposed of or satisfied, the amount being the difference between the reduced basis as provided above and the amount realized therefor. Only in rare and extraordinary cases does property have no fair market value.

Sections 39.44-2, 39.44-3 and 39.44-4 of Treasury Regulations 118, promulgated under the Internal Revenue Code of 1939, applicable to the taxable years 1952 and 1953, are substantially identical with the sections set out above.

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